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OLD-AGE ANNUITIES IN TIME OF INFLATION

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OLD-AGE ANNUITIES IN TIME OF INFLATION

THE RISE since mid-1956 in prices of many consumer goods has again directed public attention to the plight in time of inflation of older persons dependent upon annuities, pensions, social security benefits, and other types of fixed or inflexible income.[1]

The importance of maintaining the purchasing power of the rapidly increasing number of fixed income receivers has led to a search for some kind of old-age insurance that will keep the money incomes of retired persons in step with changes in the cost of living. The most interesting development in this field has been the emergence of variable-yield insurance plans under which policyholders' premiums are invested in common stocks and retirement annuities move up or down in accordance with the yield from those "inflation-compensating" securities.

Effects of Rising Prices on Value of Annuities

The man who received a moderate inheritance in the mid-1930s and used it to buy an annuity contract which would begin paying off after 20 years is now receiving payments in dollars worth no more than half the dollars he invested. Not only has the value of the dollar fallen sharply over the last two decades, but—partly as a result of inflation—taxes have more than doubled, so that the annuitant has considerably less buying power than he expected when planning for his retirement.

A study published in September by the National Industrial Conference Board showed that a married couple with two children would now need a gross income of $6,122 to command the same buying power it enjoyed in 1939 on an income of $3,000. A family with a 1939 income of $5,000 would need $10,583; a $10,000 family, $22,428.

[1] Adlai E. Stevenson said in a Labor Day speech at Detroit, Sept. 3, that while all consumers are victims of inflation, the millions who live on fixed incomes are "the worst sufferers." Secretary of the Treasury Humphrey described inflation, Sept. 24, as "the cruelest form of theft—a theft with the greatest harm to those least able to protect themselves."

Governors of the World Bank, meeting at Washington Sept. 25, were told by Under Secretary of the Treasury W. Randolph Burgess that the American economy was still beset with "unrelenting and powerful" inflationary pressures. While a balanced budget was helping to maintain stability of the dollar, Burgess doubted that a completely successful balance between inflation and deflation would ever be possible.

Many economists believe that a modern, dynamic economy operating under democratic government has built-in inflationary forces. The strong position of organized labor makes for larger wage costs and higher prices. The government, committed to full employment and maximum production, is obliged to subsidize depressed segments of the economy and to counter business recessions with government spending. Borrowing and taxation to pay the costs of national security, farm benefits, and expanding social welfare activities add to other inflationary forces. For these and many other reasons it is maintained that no government concerned with the welfare of its people can keep the value of its currency constant over a long period, that slow dilution of the currency's buying power is one of the inescapable costs of economic growth.

While many insurance executives agree that a long-term rise in the price level is probably unavoidable, few share the belief that a little inflation from year to year is a good thing. Ray D. Murphy, Equitable Life Assurance Society board chairman, told the annual convention of the National Association of Life Underwriters, Sept. 26, that "an increase of 2 per cent to 3 per cent a year in the price level would destroy the effectiveness of social benefits whether promised by government or by private corporations."

Dealing with the effects of past inflation on insurance beneficiaries in testimony before a New Jersey legislative committee last spring, Carroll M. Shanks, president of the Prudential Insurance Co., said "Annuity incomes that seemed adequate when purchased years ago today often fail to meet the buyer's needs, primarily because of the impact of inflation on the purchasing power of the dollar." [2] What the beneficiary of an annuity or the recipient of an

[2] Statement submitted to Business Affairs Committee, New Jersey Senate, Trenton, June 22, 1956.

old-age pension needs is assured buying power, and conventional annuities have not been meeting that need.

VARIABLE-YIELD ANNUITIES AS POSSIBLE SOLUTION

The variable-yield annuity has won the attention of a growing number of life insurance executives as one possible means of meeting the problem of providing undiluted income in retirement. As Louis W. Dawson, president of the Mutual Life Insurance Co., has said "When an individual arranges for an annuity or . . . an income settlement on his life insurance policy . . . he is seeking security in the form of purchasing power for himself or his family." "If fixed dollars will not adequately provide that purchasing power," Dawson continued, "then he wants something else."

According to George E. Johnson, president of the Equity Annuity Life Insurance Co. and one of the pioneers in the field of variable-yield insurance, "Variable life annuities were developed because the existing types of conventional fixed annuities were not meeting the needs of the American public." [3] Advocates of the variable-yield annuity point out that while holdings of life insurance and mutual fund shares have increased rapidly in recent years, the number of individual life annuities in force has declined. Since the peak year of 1952, when 1,279,000 individual annuities were in force, the number has fallen to 1,252,000. Prudential, the second largest life insurance company in the country, is reported to have sold only 517 such annuities last year, with three times that many going off its books.[4]

As evidence of a growing demand for variable-yield insurance, its advocates point not only to the widespread interest shown by individuals, employers, and trade unions, but more significantly to the adoption of different types of variable annuity plans by a wide variety of organizations of national stature.

The College Retirement Equities Fund, an insurance organization whose benefits are available only to staff members of educational institutions, has been issuing variable

[3] Paper presented at the Fourth Annual Miami Insurance Law Conference, Coral Gables, Fla., Mar. 19, 1956.

[4] A given premium now buys a smaller annuity than formerly both (1) because yields of the debt obligations in which the premiums are invested have declined, and (2) because annuitants are living longer and the annuity payments must be stretched out over a greater number of years.

annuities since 1952. And pension plans based on the principle of common-stock investment and variable-yield benefits have been set up by more than a dozen establishments. These include such enterprises as Boeing Airplane Co., Chemstrand Corp., Long Island Lighting Corp., and Pan American World Airways; such investment houses as Kidder, Peabody & Co. and Smith, Barney & Co.; and a scientific research organization, the Carnegie Institution of Washington.

Investment of insurance and pension funds in common stocks, it is argued, provides both a hedge against inflation and an opportunity to share in growth of the economy. For years charitable trusts and endowment funds have been investing in carefully chosen equities, and the practice has won increasing approval from regulatory authorities. But life insurance companies are forbidden by law to put more than a fraction of their funds in equities; more than 90 per cent of their assets must be kept in fixed-interest obligations.[5]

As a result, holders of life insurance policies have been able to "gain little or nothing from the booming economy that their savings . . . support." Within recent years, however, the belief has spread that "without impairing either the sanctity or safety of the life insurance contract, some methods must be found to improve . . . investment yields and . . . pass on to the millions of little life insurance savers some of the benefits of the growing economy." [6]

Effort to Win Go-Ahead for New Kind of Insurance

The campaign to obtain permission of state authorities to sell variable annuities is being pressed on one front by Prudential, one of the life insurance giants, and defended on another by Variable Annuity Life Insurance Co. (VALIC) of Washington, D. C., a small firm organized in 1955. Opposing them and their supporters are a majority of the life insurance companies, led by Metropolitan Life, the nation's biggest, the New York and American stock exchanges, and various associations representing the investment banking and securities industry.

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[5] Statistics compiled by the Variable Annuity Life Insurance Co. show that in the past two decades while common stocks have yielded an average annual return of 10.58 per cent, about equally divided between dividends and appreciation, the interest rate earned by all life insurance companies has averaged only 3.31 per cent.

[6] Robert Sheehan, "Life Insurance: $84-Billion Dilemma," *Fortune*, February 1955, pp. 113, 114.

Only VALIC and two other small companies, the Participating Life Insurance Co. of Rogers, Ark., and the Equity Annuity Life Insurance Co. of Washington, D. C., are in the business of selling variable annuities at present.[7] The Arkansas company, established about two years, is the oldest and the least publicized of the three; Equity, organized within the past few months, is the newest.

Prudential has been trying since 1955 to get the legislature of its home state (New Jersey) to adopt legislation that would authorize sale of variable annuities. Earlier this year, three authorization bills were passed by the State Assembly but the Business Affairs Committee of the Senate deferred action until November. Similar efforts have failed in Maryland, New York, New Hampshire, and Texas. The Massachusetts legislature considered an authorization bill this year and is expected to take it up again in 1957. In several states sale of variable-yield contracts has been stymied by rulings of the local insurance authorities.

The Variable Annuity Life Insurance Co. was set up in Washington because the District of Columbia has no restrictions against investment of life insurance reserves in common stocks and because the local superintendent of insurance was willing to grant a charter. George E. Johnson, then its president, had tried earlier to organize a company to issue variable annuities in New York but had been unable to get the necessary changes in state law.[8] Until very recently the District was the only jurisdiction where VALIC could sell its policies, but in late August it was licensed to do business in West Virginia.[9]

The Securities and Exchange Commission last June 19 asked the U.S. District Court for the District of Columbia to enjoin sale of variable annuities by VALIC until the company had complied with various registration requirements.[10]

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[7] However, Prudential's President Shanks informed the New Jersey Senate committee last June that a University of Indiana survey had disclosed that 96 life insurance companies expected to be selling variable-yield policies within the next 18 months.

[8] A bill providing a charter for a special company to sell variable annuities sailed through both houses of the New York legislature in 1954 but was vetoed by Gov. Dewey when the state superintendent of insurance said he wanted more time to study the plan. A revised bill was introduced the next year but died in committee.

[9] Thomas J. Gillooly, Insurance Commissioner of West Virginia, wrote Robert A. Crichton, now president of VALIC: "Members of . . . [the state insurance] department are convinced that, properly sold, variable annuities have a place in the insurance business world."—Quoted in *The National Underwriter* (Life Insurance Edition), Aug. 31, 1956, p. 2.

[10] Some months earlier, the National Association of Securities Dealers had asked the Commission to rule that the variable annuity contract was a security and therefore subject to S.E.C. regulation.

S.E.C. told the court that the VALIC policies were investment contracts and certificates of participation in profit-sharing agreements within the definition of the term "security" in the Securities Act of 1933; also that the company was "engaged primarily in the business of investing, re-investing and trading in securities" within the definition of the term "investment company" in the Investment Company Act of 1940.

In Connecticut the insurance and banking commissioners have asked the Superior Court of Hartford County to enjoin the proposed sale of so-called variable-endowment policies by the American Life Insurance Association, a fraternal society, and to determine whether those contracts are subject to the state securities act. In South Carolina sale of a type of policy that combined life insurance and certain investment features was barred by a lower court in mid-1955.[11]

Scope of Present Retirement Protection

MILLIONS of Americans now depend largely or entirely on fixed incomes from commercial or social insurance plans, and their number is growing steadily. A study made by the University of Michigan Survey Research Center last year for the Institute of Life Insurance showed that 115 million persons owned some type of life insurance—legal reserve company, "G.I.," fraternal, savings banks, or some other variety.

The legal reserve life insurance companies had slightly more than five million annuity policies outstanding last year. That total comprised 1,252,000 individual and 3,473,000 group annuities, plus 320,000 so-called supplementary agreements that provide for distribution of the proceeds of life policies as income over the span of life rather than lump-sum settlements. Around 19 per cent of the annuities outstanding last year were paying out income,

[11] In issuing the order forbidding sale of such insurance, the judge characterized the contract as "an investment scheme which violates not only the letter and the spirit of the South Carolina statute, but is contrary to the purpose and theory of life insurance."—Coastal States Life Insurance Co. *v.* R. Lee Kelley, Insurance Commissioner of South Carolina, Court of Common Pleas, Richmond County, June 1955.

66 per cent had been paid up but had not started paying out, and 15 per cent were still being paid for.

Payments made under individual and group annuities reached $462 million in 1955; payments under supplementary agreements, $720 million. Other fixed-income "living benefits" paid out by life insurance companies last year included nearly $896 million in surrender values and $614 million in matured endowments, along with about $100 million in disability payments. Death benefit payments totaled more than $2.2 billion.

Social Security, Pension, and Other Old-Age Plans

About 70 million workers are now fully insured under the Social Security System and some 8 million persons were receiving monthly benefits at the beginning of this year; about 5.8 million of the latter were getting old-age and related retirement benefits and roughly 2.2 million, survivor benefits. The average monthly old-age benefit was about $62; the maximum, $108.50.

Benefit levels were raised in 1950, 1952, and 1954 to correspond with increases in price and wage levels.[12] Although Congress has been willing to grant what have amounted to cost-of-living increases in social security payments, there has always been a lag between the time living costs started up and the larger benefits became available. Presidential Candidate Stevenson called on Sept. 24 for a "comprehensive review and re-determination of the adequacy of existing O.A.S.I. and old-age assistance benefits." Mayor Robert F. Wagner, Jr., of New York City, Democratic candidate for U.S. senator in this year's election, proposed Sept. 28 that the payments be increased within the next few years "to a point where the average family in its old age will enjoy benefits of at least $200 a month."

The basic federal old-age and survivors insurance program set up in 1935 is now supplemented by a wide variety of private pension plans. Because many of these make no reports to government agencies there are no exact figures on their total number, but the Internal Revenue Service has estimated that there may be as many as 30,000 —insured, trusteed, and other types. In addition, there

[12] Average monthly payments to retired workers went from $25.13 in mid-1948 to $61.03 in mid-1955. Since the start of the social security program, rates of employer and employee contributions have been increased from 1 per cent on the first $3,000 to 2¼ percent on the first $4,200 (to start in 1957).

are thousands of pay-as-you-go plans, under which no pension fund is accumulated and pensions are simply paid out of current income. Close to 13 million employees are estimated to be covered under all types of pension plans.

Pensions and other retirement benefits are paid also to war veterans, retired federal civil servants, and railroad workers. More than 2,700,000 veterans are receiving monthly pensions, disability compensation, and subsistence allowances. About 427,000 retired railroad employees get monthly old-age and disability benefits under the Railroad Retirement Act. Some 237,000 former U.S. civil servants are on the civil service retirement rolls. In addition, monthly survivor benefits are paid to approximately 1,156,000 widows, parents, and children of deceased veterans, about 207,000 survivors of railroad workers, and some 75,000 beneficiaries of deceased civil service employees.

Along with social security benefits, Congress has upped benefits under the railroad and civil service retirement systems and has liberalized veteran benefits to compensate for declines in the value of the dollar. And trade unions have been able to win increased benefits under company plans through collective bargaining. But payments under annuity policies issued by insurance companies (and under options to become effective when life policies are due to pay off) continue to be made in the exact dollar amounts called for in the original contracts.

Operation of Variable-Yield Annuity Plans

ANNUITY contracts to provide varying, rather than fixed, payments have come to public notice only within the last few years, although examples of somewhat similar contracts can be found as far back as the 13th century. Scholars have uncovered the case of a citizen of Utrecht who in 1265 arranged for a survivorship annuity of 400 Parisian *livres*. If the purchasing power of that currency declined, the contract required that the payments be made in another currency, Tournaise *sous*, at the rate of 50 *sous* for 43 *livres*. In pre-Reformation England there was frequent use of a type of annuity known as the "carody" under which

annuitants were paid in portions of food, grants of free lodging, or privileges of using the mill or ovens of the seignior or the monastery.

From the mid-1700s until the middle of the 19th century many persons in both Europe and America participated in various types of tontines, an annuity scheme first proposed by Lorenzo Tonti, an Italian banker, to Cardinal Mazarin of France in 1653. Under a typical tontine arrangement, a number of persons invested a specified amount of money in some state or commercial venture and received on their combined capital a stipulated rate of interest. Each year the interest was divided among all surviving annuitants. Thus, the survivors stood to receive greater payments each succeeding year. Each annuitant staked his money on the chance that he would outlive the others and be able to collect their shares.

Pioneering by Teachers' Insurance Association

The phrase "variable annuity" presumably was first used and a formal variable life annuity plan was first put into effect in July 1952 by the Teachers' Insurance and Annuity Association (TIAA). The association had been established in 1918 by the Carnegie Foundation and the Carnegie Corporation as a non-profit, legal reserve life insurance company to provide retirement income for staff members of colleges and other educational institutions. It pioneered in writing what were in effect group annuities (financed by joint contributions of employers and employees) before they were offered commercially. By the end of 1955, TIAA had 90,000 policyholders, and more than 700 institutions were funding their retirement and insurance systems by means of its contracts.

A few years ago the officers became aware that as a result of inflation TIAA's conventional annuities were not meeting the needs of retired teachers. The long rise in prices had undermined retirement annuities paid in fixed dollar amounts. In many cases, according to the president of TIAA, the annuitant's plight was desperate. "The management realized that a better type of pension had to be devised if the objective of a superior retirement system for educators was to be maintained." [13]

[13] R. McAllister Lloyd, address before 37th Mid-Winter Trust Conference, American Bankers Association, New York, reprinted in *Commercial and Financial Chronicle*, Apr. 5, 1956, pp. 7, 43.

TIAA conducted an extensive economic study, which included an examination of stock market movements over the preceding 70 years. The result was establishment of an affiliated organization, the College Retirement Equities Fund (CREF), which was set up to issue variable annuities in combination with fixed dollar contracts. The variable-yield insurance was to supplement "the tried and true fixed-dollar annuity provided in retirement plans funded by TIAA contracts."

CREF was organized as a non-profit educational corporation, subject to supervision by the New York State Insurance Department, and as an adjunct to TIAA; its annuity policies are not available to the general public. Early this year, it had 26,000 participants in 500 educational institutions. Its assets exceeded $28 million, all invested in common stocks.

Basic Principles of Educators' Annuity System

The teacher who subscribes to a CREF annuity pays a fixed percentage of his salary into the fund each month, as does his employer. The payments are used to buy accumulation units, which represent a share in a pool of common stocks. The value of the units fluctuates from month to month in company with the market value of the securities in the fund. Dividends paid on the stocks are used to purchase additional units.

When the teacher retires, his *accumulation units* are converted, on a basis set forth in his contract, to a fixed number of *annuity units*. The number of annuity units payable monthly to the subscriber remains constant during his lifetime. But the number of dollars into which they are converted varies from year to year in accordance with changes in subscriber mortality and the market values and dividends of the stocks in the fund. Unlike the value of the accumulation units, which is determined monthly, the value of the annuity units is determined once a year, on Mar. 31, and remains unchanged for the ensuing 12 months. Actual values of annuity units have varied as follows: 1952-53, $10; 1953-54, $9.46; 1954-55, $10.74; and 1955-56, $14.11.

The TIAA study had shown that in the preceding half century a retirement plan under which roughly half of the funds were invested in fixed interest securities and half in equities would have had the best chance of providing a re-

tirement income that moved up or down with the cost of living. Therefore, TIAA-CREF policyholders may put not more than 50 per cent of their premiums into CREF; the remainder must go into TIAA.

According to TIAA, a policyholder who had followed such a 50-50 system since 1900 would almost always have received substantially more than would have been realized through purchase of a fixed dollar annuity with the same premiums; the only year in which he would have received less was 1932. Ninety per cent of the teachers who have TIAA-CREF policies have chosen to have the maximum permissible amount of their contributions paid into CREF.

Because the mistake most frequently made in stock market investment is to put too much money into, or take too much out of, the market at any one time, CREF discourages large single premiums and generally does not permit transfers between it and TIAA. Moreover, CREF accumulations have no cash or loan values. In order to gain the benefits of dollar cost averaging, the fund is kept fully invested at all times.

Features of Variable Annuities Publicly Offered

The mechanics of variable annuity plans now open to the public in certain localities, and those that may become available in the future, vary slightly, but in theory and operation the contracts are basically similar to those issued by CREF. The variable-annuity companies use policyholders' premiums (minus deductions for expenses, mortality variations, etc.) to buy units in a pool made up largely or entirely of common stocks.

The pool units represent the policyholder's current proportionate share in the securities held by the company. The number of units credited to the policyholder varies with each premium because the dollar value of each unit, computed monthly, fluctuates with the market. At frequent intervals the policyholder is given a statement showing the number of units credited to his account and their current value. He is credited also with a proportionate share of the dividends and other earnings on company investments.

When the annuity matures, the policyholder's accumulated units are converted into a number of pay-out units

according to a formula stated in his policy. That number remains constant thereafter, but the number of dollars for which the pay-out units are exchanged fluctuates in accordance with changes in the value of the units.[14] The value is re-determined periodically to reflect changes in the market value and yield of the equities.

Unlike CREF, which has a rule that its participants can put only half of their premiums into its policies and must put the remainder in a TIAA fixed annuity, the companies now offering, or planning to offer, variable annuities may or may not provide for such balancing of investments. Some will leave it to the individual; others propose to undertake balancing according to certain formulas. Whereas the CREF variable annuities do not pay death benefits, the commercial policies provide that if the holder dies, his beneficiary will receive the value of the accumulation units to his credit.

In further contrast with CREF policies, commercial variable annuities stipulate that at any time before annuity payments have begun, the policyholder may surrender his policy and receive a cash payment equal to the value of the units he has accumulated up to that time. During the first five years of the policy's life, a small surrender charge is made. At any time while the policyholder is paying premiums, he can cash in part of his accumulation units to meet emergency needs.

Reasoning Behind Plans Based on Yield of Equities

The essence of the variable-yield concept, George E. Johnson has said, is the "coupling of life annuities with equity investments so that the resulting annuity will vary to reflect changes in the investment experience of the company or changes in the cost of living." [15] Proponents of such equity annuities base much of their case on the fact that while the long-term trend in the value of common stocks has been upward, the trend in value of the dollar has been downward.

Wilford J. Eiteman, professor of finance at the University of Michigan, has said that the variable annuity is "only

[14] "Whereas the conventional annuity provides a *fixed dollar* payment, the variable annuity provides a *fixed unit* payment."—Leonard E. Morissey (assistant professor of accounting, Dartmouth College), "Controversy Over Variable Annuities," *Challenge*, April 1956, p. 55.

[15] Paper presented at Fourth Annual Miami Insurance Law Conference, Coral Gables, Fla., Mar. 19, 1956.

a device which makes it possible to carry out the intentions of a fixed annuity contract." According to indexes of stock values and dollar values prepared by Eiteman, the value of a unit of common stock rose some 70 per cent between 1880 and 1955, with intermittent fluctuations. On the other hand, the value of the dollar at the end of the period had fallen by two-thirds; its purchasing power had declined in 44 years, remained constant in 11, gone up slightly in 19.[16]

The Variable Annuity Life Insurance Co. has made a comparison of the hypothetical experiences of a man who bought a conventional annuity in 1920 and one who might have bought a variable annuity if then available. It assumed that in each case the annual premium was $1,000, payable for 20 years. Starting in 1940, the purchaser of the conventional annuity would have received $2,510 each year. The holder of the variable annuity would have received—assuming that the yield from his annuity followed the index of stock prices—payments ranging from $2,410 in 1940 to $6,650 in 1954. In only the first three years, 1940-41-42, would the payments under the variable annuity have been less than the fixed dollar payments under the conventional annuity.

Correlation Between Stock Prices and Living Costs

Stock market prices have tended to move in the same direction as the cost of living, but at times they have moved in an opposite direction. Johnson concedes that the correlation is by no means absolute, but he contends that "The risk of deviation is slight compared with the greater risk of being completely unprotected against dollar value fluctuations." [17] On the other hand figures for the 75-year period 1880-1955, compiled by M. Albert Linton, chairman of the board of the Provident Mutual Life Insurance Co., show that the index of stock prices ran well below the index of living costs for a decade after the United States entered World War I and again during the early 1930s and parts of the 1940s. During some of those 75 years, Linton has noted, holders of variable annuities would have felt themselves "on the crest of the wave" but in others they would have felt "depressed." [18]

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[16] Testimony before Business Affairs Committee, New Jersey Senate, Trenton, June 22, 1956.

[17] George E. Johnson, "Immediate Variable Life Annuities," *Trusts and Estates Magazine*, February 1956.

[18] Paper presented before American Finance Association, New York, Dec. 28, 1955.

Opponents of variable annuities point particularly to the hardships holders of such policies would have suffered in the years immediately after the 1929 stock market crash. Johnson has replied that the 1929 collapse obscures "the long-range picture of successful investment in common stocks . . . [and] causes over-prudent investors to close their eyes to all of the good years." He has urged that investors view the events of 1929-1932 in perspective, remembering that such a period "is a very short one in a man's lifetime" and that "the accumulation and pay-out period under a life annuity often covers a span of 50 years." [19]

Champions of annuities based on common stock yields point to application of the theory of dollar cost averaging as an effective safeguard against fluctuations of the market. Under that theory, the investor puts an equal number of dollars into stocks at regular intervals and thus buys at both high and low prices over a long period. But because his dollars will buy more shares when prices are low, and low-cost shares will represent the largest part of his portfolio, his average cost per share will be lower than the average price paid. Proponents of the variable annuity contend that, because the annuitant in most cases would pay premiums over a period of many years and those premiums would be invested over the same period without regard to the prices of stocks at any one time, the risk from sharp falls in stock prices would be greatly reduced.

Frederic W. Ecker, president of Metropolitan Life, told the New Jersey Senate committee last June, however, that dollar cost averaging had the following weakness: "If a depression should occur in the period when the individual is . . . making his premium payments, there would no doubt be many individuals who would not continue their payments. Yet this would be just the time when, to make the dollar-averaging theory work, it would be most important to continue . . . [them], for presumably during this depression period common stock prices would be low, and a larger number of units would be purchased by the same premium dollars."

[19] George E. Johnson, "Immediate Variable Life Annuities," *Trusts and Estates Magazine*, February 1956.

Variable Annuities and the Public Interest

AMONG issues of public policy raised by the offering of variable-yield contracts for sale to the general public is the question whether the new kind of contract is really a type of insurance or a type of security, and—depending on the answer to that question—the further question, who should sell it, insurance companies or dealers in securities, and who should regulate it, the states or the federal government. Proponents of the variable annuity contract maintain that it is insurance with an attractive investment aspect; its opponents say it is an investment with an insurance veneer.

President Shanks of Prudential said at the New Jersey legislative hearings last June 22 that even if the courts held that variable annuities were subject to jurisdiction of the Federal Securities and Exchange Commission his company "would not alter [its] plans to go ahead." Vice-President Charles G. Dougherty of Metropolitan has said on the other hand: "Our present thinking is that we wouldn't touch variable annuities, regardless of what happens." [20]

A declaration by the American Life Convention states that "If the variable annuity business is to be engaged in, such business should be transacted by corporations formed especially for that purpose and strictly regulated by government and . . . such business should not be engaged in directly by life insurance companies." Prudential spokesmen have maintained, however, that "The public would be better served by the sale of variable annuities by agents who also sell life insurance and conventional fixed-amount plans than by the sale of variable plans by agents who sell nothing but variable plans." [21]

Strong dissent from Prudential's view has been expressed by Metropolitan's President Ecker. He testified last spring that "The insurance industry's answer to the problem of rising prices is to launch a fight against infla-

[20] Quoted in *Nation's Business*, April 1956, p. 64.

[21] J. Edward Day and Meyer Melnikoff (respectively, associate general solicitor and associate actuary of Prudential), "The Variable Annuity as a Life Insurance Company Product," *Journal of the American Society of Chartered Life Underwriters*, Winter 1955, p. 49.

tion rather than . . . [to fashion] devices based on the acceptance of inflation as inevitable." And he went on: "How is the conscientious life underwriter . . . going to sell . . . security on the one hand and at the same time be prepared to sell what in effect amounts to speculation on the other? . . . Let the life insurance companies . . . sell guaranteed security, as they always have, and let others sell shares in these common stock funds."

The companies that are marketing or proposing to market variable annuities argue that no investment company could guarantee to spread the principal amount of an investment and its earnings over an entire lifetime. Noting that equities long have been recognized as sound media for fiduciary investing by banks and trust companies, they ask: Why should a person who wants to buy an annuity be restricted by law to buying one that is invested solely in low-yielding debt obligations?

Federal vs. State Regulation of New Insurance

The National Association of Securities Dealers holds that variable annuities are securities and has recommended that, when sold in interstate commerce, they should be made to conform with the disclosure requirements of the federal securities statutes. A committee of the National Association of Securities Administrators, the organization of state securities officials, also maintains that variable annuities should be subject to the same degree of regulation under the state and federal securities laws as investment securities.

Companies that wish to sell variable annuities deny that their contracts are securities and assert that the securities industry is trying to choke off competition. They note that many corporations have set up pension plans that authorize the trustee to invest retirement funds in common stocks, and they hold that they should be allowed to compete for such business. Present and would-be sellers of variable annuities contend, moreover, that the state insurance departments can regulate the business involved in sale of the new contracts just as effectively as they have regulated that connected with conventional policies. The insurance companies interested in selling the new type of annuity (also those not intending to sell it) are anxious to keep their business under state regulation rather than have it put under the government at Washington.

Fears of Undue Concentration of Economic Power

Inasmuch as life insurance companies are responsible for the investment of a substantial portion of the nation's total savings, there is a public interest in the way in which those funds are put to work. How the companies handle their $90 billion of assets bears great significance not only for their 103 million policyholders but for the entire economy as well. Buying of equities by insurance companies would increase greatly if many of them entered the variable annuities field.

Stock holdings of life insurance companies have increased annually since 1942, but they still amount to only four per cent of total assets, and nearly half of all the stocks held are preferred's.[22] Ownership of equities is limited by company attitudes as well as by state laws. New York allows life insurance companies to invest only three per cent of their assets, or one-third of their surplus, whichever is less, in common stocks.[23] Some other states authorize investment of a slightly higher percentage; a few forbid home companies to hold any common stocks. In states which have no such restrictions in their statutes the limitations, if any, are imposed by the state regulatory authorities.

Opponents of variable annuities point out that life insurance companies already are responsible for about half of the bond financing for business and industry. If the same companies were to acquire large holdings of common stocks in connection with their sale of variable-yield contracts, they might be in position to dominate corporate industry. At any rate, it is feared that large-scale investment in common stocks would give rise to charges of undue concentration of economic power and invite stringent regulation of the life insurance industry by the federal government. President Ecker of Metropolitan has said that it is not in the public interest for life insurance companies to control industry—"or even to put themselves in the position of being accused of such control."

Other observers have expressed concern about the effect that diversion of funds from present life insurance com-

[22] As of the end of 1955, more than 43 per cent of total assets were invested in bonds, nearly 33 per cent in mortgages, about 10 per cent in U.S. government securities, 3 per cent in real estate, and the remainder in stocks, policy loans, and miscellaneous assets.

[23] Companies licensed to do business in New York hold more than four-fifths of all life insurance company assets. An insurance industry proposal that New York companies be permitted to invest up to five per cent of their assets in common stocks was supported in testimony by the state superintendent of insurance, Sept. 29, before the Joint Legislative Committee on Insurance Rates and Regulation.

pany investments to equities would have upon securities markets. They point out that buying of common stocks by pension funds, investment trusts, mutual funds and other institutional investors recently put some stocks in short supply, and that heavy buying by insurance companies might result in future shortages of high-grade equities.

Arnold R. LaForce, a Metropolitan vice president, has directed attention to another possible result:

> In effect the variable annuity plan, as presently conceived, . . . constitutes nothing more nor less than compulsory dollar averaging on a gigantic scale in a relatively small list of our top flight industrial and public utility corporations. Constant concentrated demand for this type will have but one effect—a substantial price rise for certain stocks that presently are selling on relatively high price-earnings ratios and low yields.

"Hence," LaForce concluded, "quality common stocks as a group could become overvalued in relation to other forms of investment, and we might well have the anomaly of inflation in the [very] vehicle which was designed to protect the annuity holder against inflation." [24]

[24] Address before the New York City Chapter of Chartered Life Underwriters, New York, Jan. 18, 1956, reprinted in *Commercial and Financial Chronicle*, Jan. 26, 1956, p. 79.